No. 11,718

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION (a national banking association), *Appellant,*	
vs.	
UNITED STATES OF AMERICA, *Appellee.*	

On Appeal from the District Court of the United States for the Northern District of California.

BRIEF FOR APPELLEE.

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BRIEF FOR APPELLEE.

OPINION BELOW.

The opinion of the District Court (R. 106-112) is reported at 69 F. Supp. 932.

JURISDICTION.

This is a suit against the United States for refund of amounts paid by the Bank of America National Trust and Savings Association, herein sometimes referred to as the taxpayer, as additional federal income taxes and interest for the taxable years 1938 and 1939. (R. 2-17.) The disputed deficiencies in taxes and in-

terest were paid on March 17, 1942, to Clifford C. Anglim, Collector of Internal Revenue for the First District of California, who was no longer in office when this suit was filed. (R. 38-39, 40, 41.) On March 14, 1942, the taxpayer filed a claim for refund of $115,000 paid as income tax for the year 1938, and on April 25, 1942, it filed a further claim for refund of $273,620.46 paid as income tax for that year. Also on April 25, 1942, it filed its claim for refund of $97,477.46. These claims were rejected by the Commissioner of Internal Revenue on April 4, 1944. (R. 39.) This suit was filed November 25, 1944 (R. 140), within the time provided by Section 3772 of the Internal Revenue Code, for the recovery of $54,382.97 paid as income taxes for the year 1938 and $50,531.19 paid as income taxes for the year 1939. (R. 16.) The taxpayer's claims for refund for the years 1938 and 1939 were based upon the same grounds on which this suit is based, and the amounts sought to be recovered in this suit were included in the amounts covered by the refund claims for 1938 and 1939. (R. 39.) Jurisdiction was conferred on the District Court by Section 24, Twentieth, of the Judicial Code, as amended. It was agreed in the Court below, without prejudice to the parties with respect to the issues here involved, that the taxpayer was entitled to refunds of taxes and deficiency interest for the years involved in the aggregate sum of $15,475.78. (R. 58-59, 115.) On December 5, 1946, the District Court filed an opinion in which it held that the taxpayer is not entitled to recover any amount in excess of that agreed to by the parties (R. 106-112), and on March 14, 1947, the District

Court entered its judgment in favor of the taxpayer in the sum of $15,475.78, with interest thereon as provided by law, and its costs. (R. 130-131.) Within three months thereof, and on June 9, 1947, the taxpayer filed its notice of appeal pursuant to the provisions of Section 128(a) of the Judicial Code, as amended.

QUESTION PRESENTED.

In its federal income tax returns for the taxable years 1932 to 1935, inclusive, the taxpayer deducted from gross income as depreciation upon its banking furniture and fixtures amounts in excess of the depreciation on such assets charged off on its books of account for those years. The amounts charged off as such depreciation on its tax returns exceeded reasonable allowances for depreciation for income tax purposes, but by reason of net losses sustained in those years such deductions did not result in any tax benefit to the taxpayer. The only question involved in this appeal is whether, under the stipulated facts, the basis for computing the taxpayer's allowance for depreciation on such assets under Sections 23 (1) and (n), 113 (b) (1) (B), and 114 of the Revenue Act of 1938 and the Internal Revenue Code for the taxable years 1938 and 1939 should be reduced by the excessive depreciation claimed in the taxpayer's returns for 1932 to 1935, inclusive, as held by the Commissioner and by the Court below, or only by the lesser amounts properly allowable under the statute for those years, as contended by the taxpayer.

STATUTES AND REGULATIONS INVOLVED.

The pertinent provisions of the statutes and Treasury Regulations involved are printed in the Appendix, *infra.*

STATEMENT.

The facts of this case are not in dispute. They are set forth in two stipulations of facts agreed to by the parties (R. 28-37, 38-68) together with the exhibits attached to the second stipulation of facts,[1] and are fully summarized in the findings made by the District Court. (R. 114-127.)

As stated above, this is a suit against the United States for refund of amounts paid as additional federal income tax for the years 1938 and 1939, and the only question involved on this appeal is the proper basis for determining a reasonable allowance for depreciation upon the taxpayer's banking furniture and fixtures for those years. The material facts necessary to a consideration of this issue can be stated briefly.

For each of the years 1932 and 1933, Transamerica Corporation filed a consolidated return of income in which it included the income and deductions of the taxpayer, an affiliated company. Those returns disclosed a large consolidated net loss for each year, including net losses of $12,047,167.29 and $10,827,436.79 for the taxpayer for 1932 and 1933, respectively. For

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[1] A part of these exhibits are printed in the record. (R. 144-290.) The remainder were omitted by agreement of the parties. (R. 292-295.)

the years 1934 and 1935 the taxpayer filed separate corporation income tax returns in which it reported net losses in the respective years of $13,689,532.14 and $11,179,336.88. (R. 117-118.)[2] In arriving at these net losses for the respective years the taxpayer deducted the following amounts on its returns as depreciation (R. 117-118, 120):

Year	Amount
1932	$1,947,819.34
1933	1,698,146.84
1934	1,620,826.23
1935	1,546,767.79

Included in the above deductions for depreciation claimed by the taxpayer on its returns for those years were the following amounts deducted as depreciation on the taxpayer's banking furniture and fixtures (R. 118):

Year	Furniture	Fixtures	Total
1932	$ 335,718.78	$ 588,120.12	$ 923,838.90
1933	323,173.85	564,776.58	887,950.43
1934	316,130.67	553,757.42	869,888.09
1935	310,258.18	524,051.53	834,309.71
	$1,285,281.48	$2,230,705.55	$3,515,987.13

The amounts charged off on the taxpayer's books as depreciation of furniture and fixtures for these same years were (R. 118):

Year	Furniture	Fixtures	Total
1932	$ 168,913.59	$ 343,962.21	$ 512,875.80
1933	170,441.84	336,503.66	506,945.50
1934	172,090.20	342,636.37	514,726.57
1935	190,641.70	374,517.80	565,159.50
	$ 702,087.33	$1,397,620.04	$2,099,707.37

[2]The net losses for 1934 and 1935 as found by the District Court seem to differ from the net losses reported on the 1934 and 1935 returns (R. 246, 254), but if the finding is in error it still has no bearing upon the question involved.

The deductions thus taken on the taxpayer's income tax returns for the years 1932 to 1935, inclusive, therefore, exceeded the amounts charged off on its books as depreciation of the same property for the respective years involved by $410,963.10, $381,004.93, $355,161.52, and $269,150.21, or a total of $1,416,279.76. (R. 118-119.)

Prior to 1931 the taxpayer deducted from gross income shown on its tax returns the same amounts for depreciation on its furniture and fixtures as it charged off on its books; that is, eight per cent per annum of the original cost and on an estimated useful life of 12½ years. In 1932 the taxpayer estimated the useful life of its furniture and fixtures on hand December 31, 1931, was 12½ years from that date and of new furniture 15 years from date of purchase. Thereupon it changed its depreciation rate for bookkeeping purposes by using a rate of eight per cent of the residual value (meaning cost less accumulated depreciation) of the furniture and fixtures on hand December 31, 1931, and six and two-thirds per cent on new acquisitions thereafter. However, the taxpayer continued to compute its depreciation at the rate of eight per cent per annum on original cost in computing its depreciation on its tax returns for each of the years 1932 to 1937, inclusive. For the years 1932 to 1937, inclusive, the taxpayer thus deducted from gross income on its tax returns a larger amount for depreciation on furniture and fixtures than it charged off on its books. However, for the years not involved (1938 and 1939) the taxpayer deducted the same amounts as it charged off. (R. 119.)

The taxpayer's returns for 1932, 1933 and 1934 were successively examined by local internal revenue agents. When each of those agents had proceeded far enough in his audit to develop the fact that no tax liability existed for the period under examination by him, he submitted to the Internal Revenue Agent in Charge a report to that effect with the recommendation that the return for the particular year be accepted as filed. The reports and returns for those three years, after review and approval of each successive report in the office of the Internal Revenue Agent in Charge, were transmitted to the Bureau of Internal Revenue at Washington, D. C., with the recommendation of the field office that the returns be accepted as filed. When those returns and reports covering the years 1932, 1933 and 1934 were successively received by the Bureau they were reviewed, accepted and sent to the closed files. (R. 120.)

During February, 1937, Internal Revenue Agent Mooney began his audit and investigation of taxpayer's 1935 income tax return and spent several days at the taxpayer's office on that assignment. During the course of his audit he ascertained that depreciation had been taken on buildings and equipment and on furniture and fixtures to the extent of $487,999.41 in excess of that charged off on the books for the year 1935 and orally questioned the accuracy of the deduction in conversation with taxpayer's tax counsel. Taxpayer's tax counsel stated to Revenue Agent Mooney that the depreciation taken on the return was excessive and requested him to cooperate in the preparation of corrected depreciation schedules. After some

further check of other items in the return, Agent Mooney concluded that no matter what adjustments or corrections, including any possible correction of the depreciation deduction, might be made to the returned net loss, there would still be no taxable income or tax due for that year. He then orally advised the taxpayer's tax counsel his conclusion to that effect and also advised him that under the practice of the Internal Revenue Agent's office he could not compile or aid in the compilation of revised depreciation schedules for the purpose of adjusting the depreciation deduction where he was satisfied that the adjustments would not offset the net loss reported on the tax return. (R. 121.)

On July 9, 1937, Revenue Agent Mooney submitted a report to the Internal Revenue Agent in Charge at San Francisco recommending that the 1935 return of the taxpayer be accepted as filed. That report, after review and approval in the office of the Internal Revenue Agent in Charge, was forwarded with the 1935 return to the Bureau with the recommendation that the taxpayer's 1935 return be accepted as filed. When that 1935 return and report were received in the Bureau, the return was reviewed, accepted and sent to the closed files. (R. 121-122.)

The procedure followed by the Bureau of Internal Revenue and its field agents in connection with the examination, audit and review of the above-mentioned income tax returns for the years 1932 to 1935, inclusive, is in accordance with the established administrative practice of the Bureau in such cases. (R. 122.)

No other action than herein stated has ever been taken by the Commissioner of Internal Revenue with respect to the income tax returns of the taxpayer for the years 1932 to 1935, inclusive. (R. 122.)

The income tax return filed by the taxpayer for 1936 also showed a net loss and was handled in the same manner. After review by the Bureau it, too, was accepted and sent to the closed files. Subsequently, in June, 1939, the Bureau, in connection with the audit of the taxpayer's 1937 return, reaudited the taxpayer's 1936 return and determined deficiencies in income tax for both years which were due in part to the Commissioner's disallowance of excess depreciation taken on the taxpayer's furniture and fixtures.[3] The taxpayer appealed from that determination to the Tax Court and later, in a settlement of the various issues involved in the 1936-1937 case, the taxpayer abandoned its contentions with respect to this disallowance of excess depreciation with the express understanding that the settlement for those years was made without prejudice to either party as to any issue involved in the determination of the taxpayer's income tax liability for subsequent years. (R. 122-123.)

Under the applicable Treasury Regulations, rulings and administrative procedure in effect when the original income tax returns of the taxpayer were filed for

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[3]For the year 1936 the taxpayer had deducted $845,024.08 as depreciation, of which the Commissioner disallowed $492,240.97; and for 1937 it had deducted $884,399.58, of which the Commissioner disallowed $489,595.25. (R. 123.)

the years 1932 to 1935, inclusive, and when those returns were examined and reviewed by the Bureau of Internal Revenue, taxpayers were not required to charge off upon their books the same amounts of depreciation as had been deducted from gross income in their income tax returns, provided they maintained appropriate auxiliary records and furnished to or submitted for inspection by representatives of the Bureau sufficient detailed data or schedules to enable the Bureau's representatives to check or verify the correctness of the deduction taken. (R. 123-124.)

The taxpayer filled out Reconciliation Schedule L on page three of its income tax returns for the years 1932 to 1935, showing that the depreciation deducted in its returns exceeded the depreciation charged off on its books for each of those years. (R. 124.)

Irrespective of the discrepancy between the depreciation upon furniture and fixtures as charged off upon the books and as taken in the taxpayer's income tax returns for the years 1932 to 1935, inclusive, official revision of the depreciation schedules was not considered by the Bureau of Internal Revenue until an audit was made of a return showing a tax liability. (R. 124.)

In December, 1939, when Engineer Revenue Agent Clack called upon representatives of the taxpayer to discuss a procedure for revision of the taxpayer's depreciation schedules in connection with the Bureau's then pending examination of its income tax returns for the years 1937, 1938 and 1939 and its

pending reexamination of taxpayer's income tax return for the year 1936, the statute of limitation had already run with respect to the years 1932 to 1935, inclusive. (R. 124.)

Subsequently the Revenue Agents made an audit for the years 1936 to 1939 and submitted reports covering those four years. Those reports were submitted by the field agents in 1941 or later and included, among other things, a revised schedule of depreciation of the furniture and fixtures for the years 1932 to 1935, inclusive, and a readjustment of the depreciable base as of December 31, 1935. The Revenue Agents "allowed" as the annual deductions for depreciation the amounts charged off on the books therefor and added to the unexhausted base as of December 31, 1935, the aggregate amount of excess depreciation deducted in the tax returns for each of the years 1932 to 1935, inclusive. This addition was disapproved by the Commissioner. (R. 124-125.)

In auditing the taxpayer's returns for 1936, 1937, 1938, and 1939 the Commissioner made certain determinations as to the useful life of the taxpayer's furniture and fixtures which are not material here. In applying such determinations in computing the taxpayer's allowance for depreciation for the years 1938 and 1939 the Commissioner used the unexhausted base of such furniture and fixtures as of December 31, 1935, as reflected on the tax return for 1935, rather than the unexhausted base as shown on that return increased by the excessive depreciation

deducted by the taxpayer in its returns for the years 1932 to 1935, inclusive, as was done by the examining agents. (R. 125-126.)

After the commencement of this action the parties agreed that the amounts charged off upon the taxpayer's books as depreciation of its furniture and fixtures in each of the years 1932 to 1935, inclusive, were a reasonable provision for such depreciation in those years. (R. 126.)

The Commissioner has consistently used the cost of taxpayer's furniture and fixtures as taken from the books of the taxpayer in computing its allowance of depreciation of that property. (R. 126.)

On April 21, 1945, Transamerica Corporation filed amended consolidated corporation income tax returns, including therein amended income tax returns of the taxpayer, for the years 1932 and 1933; and on the same data the taxpayer filed amended income tax returns for the years 1934 and 1935. Those amended returns showed that the taxpayer (for income tax purposes) sustained net losses in each of those four years. In each of those amended returns the taxpayer recomputed its deduction for depreciation of furniture and fixtures to conform to the depreciation of that property as charged off upon its books for those same years. (R. 126.)

Under the established administrative practice of the Bureau of Internal Revenue during the period now under review, when amended returns are filed by any taxpayer such returns are given consideration

and are acted upon only if filed within the statutory period of limitation applicable to the period covered by the amended return. (R. 126-127.)

Up to the time of the execution of the two stipulations of fact submitted and filed in this proceeding, the Bureau of Internal Revenue has never given any consideration to the amended returns filed by or in behalf of the taxpayer in April, 1945, for the years 1932 to 1935, inclusive. (R. 127.)

After the case was submitted to the Court below, counsel for the taxpayer filed a motion to set aside the order of submission and for leave to submit further evidence consisting of a form letter sent to Transamerica Corporation, dated July 31, 1946, over the signature of the Internal Revenue Agent in Charge at San Francisco stating that upon examination of its income tax returns for 1932 and 1933 the conclusion had been reached that they should be accepted as correct. (R. 69-74.) The Government filed an objection to this motion. (R. 75-105.) The motion was denied. (R. 113.)

On the basis of the foregoing facts the District Court sustained the Commissioner's allowance for depreciation of taxpayer's banking furniture and fixtures for the years 1938 and 1939 (R. 127-130) and the taxpayer appealed.

SUMMARY OF ARGUMENT.

The internal revenue laws applicable to the years here involved provide that in computing net income for federal income tax purposes there shall be allowed as a deduction from gross income, among other things, a reasonable allowance for exhaustion, wear and tear of property used in business. A similar allowance was provided in earlier Revenue Acts. For the years here involved the statute provides that the basis on which the allowance for depreciation is to be computed shall be the cost of such property reduced by prior exhaustion, wear and tear "to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws."

In this case the taxpayer filed income tax returns for the years 1932 to 1935, inclusive, in which it reported a large net loss for each year. In computing the net loss for each year it claimed deductions for depreciation of its furniture and fixtures which were substantially in excess of the amount properly allowable as such depreciation for each year. Internal revenue agents made preliminary examinations of these returns and were advised of the excessive deductions for depreciation. When their examinations proceeded to the point where it was clear that even if the deductions for excessive depreciation were corrected there would still be a net loss and no resulting tax liability, they so reported to the Commissioner of Internal Revenue and returned the tax returns to the Bureau of Internal Revenue where they were checked and sent to the closed files. This procedure

continued until a later year where a tax liability was indicated on the basis of a correct allowance for depreciation when the Commissioner had the returns audited and the allowance for depreciation corrected.

For the years 1938 and 1939 here involved the Commissioner computed a correct allowance for depreciation of the taxpayer's furniture and fixtures and disallowed the excessive deductions. In determining the adjusted basis under the statute for computing a reasonable allowance for these years he treated the excessive depreciation deducted in the taxpayer's returns for 1932 to 1935, inclusive, as having been "allowed" within the meaning of the applicable statute and reduced the taxpayer's cost basis of such assets accordingly. The District Court found as a fact that such excessive depreciation had been "allowed" in such prior years and sustained the Commissioner's allowance for the years here involved. Its finding is amply supported by the evidence.

There is no merit to the taxpayer's argument that the excessive depreciation deducted by the taxpayer for the years 1932 to 1935, inclusive, was not and could not have been allowed legally, and that therefore only the proper or "allowable" depreciation for those years should be deducted from its cost basis of such assets in determining its adjusted basis upon which a reasonable allowance for depreciation of such assets should be computed for the years here involved.

ARGUMENT.

THE DISTRICT COURT DID NOT ERR IN HOLDING THAT THE TAXPAYER IS NOT ENTITLED TO INCREASE ITS DEPRECIATION BASE FOR THE YEARS HERE INVOLVED BY AMOUNTS DEDUCTED AS DEPRECIATION IN PRIOR YEARS IN EXCESS OF DEPRECIATION PROPERLY ALLOWABLE FOR THOSE YEARS.

Section 23 of the Internal Revenue Code and corresponding provisions of the earlier revenue acts provide that in computing net income for federal income tax purposes there shall be allowed as a deduction, among others, a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business". Section 23 (1) of the Code, Appendix, *infra*. As to the years here involved, Section 23 (n) of the Internal Revenue Code and of the Revenue Act of 1938 (Appendix, *infra*) provide that the "basis" for computing such allowance "shall be as provided in section 114." Section 114 (Appendix, *infra*) provides that the "basis" upon which exhaustion, wear and tear, and obsolescence are to be allowed with respect to any property "shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property". So far as material here subsection (a) of Section 113 of the Code (Appendix, *infra*) provides that the unadjusted "basis" for determining gain or loss shall be the cost of the property, and subsection (b) of Section 113 (Appendix, *infra*) provides that the "adjusted basis" shall be the unadjusted basis provided in subsection (a) adjusted in accordance with subsection (b). The adjustment required by Section 113 (b) to the cost

of the taxpayer's furniture and fixtures which gives rise to the present controversy is that required by Section 113 (b)(1)(B), which reads as follows:[4]

> (1) *General rule.* Proper adjustment in respect of the property shall in all cases be made—
>
> *   *   *   *   *   *
>
> (B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, *to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws.* (Italics supplied.)

The taxpayer's position is that the excessive depreciation on furniture and fixtures deducted on its income tax returns for the years 1932 to 1935, inclusive, was not "allowed" within the meaning of the above provision and that its cost basis less allowable depreciation should not be further reduced by the excessive amounts deducted in its returns for those years. We submit there is no merit to the contention in view of the decision of the Supreme Court in *Virginian Hotel Corp. v. Helvering,* 319 U. S. 523, rehearing denied, 320 U. S. 810. In that case the taxpayer had deducted depreciation on its income tax returns on certain of its assets on a straight line basis (a certain percentage of the original cost of the items based upon the estimated useful life thereof) for each of the years 1927 to 1937, inclusive. The Commissioner did not question the depreciation claimed through the

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[4]See, also, Sections 19.23(1)-4, 19.23(1)-5, 19.23(1)-9, 19.113 (b)(1)-1, and 19.114-1 of Treasury Regulations 103 (Appendix, *infra*) and the corresponding provisions of Treasury Regulations 101 promulgated under the Revenue Act of 1938.

latter year. For 1938 the taxpayer claimed a similar deduction at the same rates, but the Commissioner, upon audit of that return, determined that the property had a longer estimated useful life than the taxpayer had used and that, therefore, lower depreciation rates should have been used. Accordingly, he determined a deficiency for 1938, and in doing so he subtracted from the cost of the assets the depreciation theretofore deducted on the taxpayer's returns. The remainder was taken as the statutory "adjusted basis" of the property for 1938 under Section 113 (b)(1)(B) of the Revenue Act of 1938 for computing the 1938 allowance, thuse resulting in a lesser deduction for that year. That taxpayer had reported taxable net income for some of the taxable years, but there, as here, a net loss had been reported for each of the taxable years 1931 through 1936; and there, as here, correction of the depreciation allowable and disallowance of the excessive deduction claimed for each of those years would still have left the taxpayer without taxable income for each of such prior years. There, as here, the taxpayer contended that the amounts of depreciation deducted for the years 1931 to 1936, inclusive, in excess of the deductions properly allowable for those years should not be subtracted from the depreciation base for 1938, and that the excessive depreciation so claimed for the loss years had not been "allowed" within the meaning of Section 113(b)(1)(B) of the 1938 Act. In the *Virginian Hotel Corp.* case, *supra,* the Supreme Court sustained the Commissioner's interpretation of the statute and his adjustment of the

taxpayer's income. Its decision is a complete answer to the contentions in this case. In rejecting the argument that the excessive depreciation deducted in the taxpayer's loss years had not been "allowed" within the meaning of the statute, that Court said (pp. 526-528):

> But we find no suggestion that "allowed," as distinguished from "allowable," depreciation is confined to those deductions which result in tax benefits. "Allowed" connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are "allowed," since tax liability is then determined on the basis of the returns. Apart from contested cases, that is indeed the only way in which deductions are "allowed." And when all deductions are treated alike by the taxpayer and by the Commissioner, it is difficult to see why some items may be said to be "allowed" and others not "allowed." It would take clear and compelling indications for us to conclude that "allowed" as used in § 113 (b) (1) (B) means something different than it does in the general setting of the revenue acts.

In answering other contentions made by the taxpayer in the *Virginian Hotel Corp.* case, the Supreme Court concluded (p. 528):

> Congress has provided for deductions of annual amounts of depreciation which, along with salvage value, will replace the original investment of the property at the time of its retire-

> ment. *United States v. Ludey, supra; Detroit Edison Co. v. Commissioner, ante,* p. 98. The rule which has been fashioned by the court below deprives the taxpayer of no portion of that deduction. Under that rule, taxpayers often will not recover their investment tax-free. But Congress has made no such guarantee. Nor has Congress indicated that a taxpayer who has obtained no tax advantage from a depreciation deduction should be allowed to take it a second time. The policy which does not permit the second deduction in case of "allowable" depreciation (*Beckridge Corp. v. Commissioner,* 129 F. 2d 318) is equally cogent as respects depreciation which is "allowed."

At the outset the taxpayer concedes that the Commissioner's method of determining its depreciation allowance for the taxable years involved was proper; that the statute requires the cost basis for depreciation to be reduced by "not less than" the allowable depreciation for prior years regardless of whether tax benefit was derived therefrom; and that the cost basis for depreciation must be reduced by the depreciation allowed in prior years even though in excess of the amount allowable "*if* that deduction was actually and legally allowed" under the income tax laws applicable to that particular year, or "*if* a tax benefit had been derived therefrom". (Br. 30.) It also magnanimously "concedes", in view of the Supreme Court's decision in the *Virginian Hotel Corp.* case, *supra,* that the "mere fact" that it obtained no tax benefit from the excessive depreciation deductions in

prior years "does not *in itself* justify a conclusion that the erroneous depreciation could not have been 'allowed'". (Br. 30.) It insists, however, that the fact that it did not receive any tax benefit from the excessive depreciation deducted in prior years, "*coupled* with" the fact that "the Commissioner knew that the deduction was excessive and that he and his agents challenged it and his agents corrected it", does justify the conclusion that "the excessive depreciation was not allowed and could not have been allowed legally". (Br. 31.)

It is because of this "*coupled* with" position of the taxpayer that we have set out at length in the foregoing statement the District Court's findings with respect to the action taken in connection with the taxpayer's returns for prior years and the usual procedure followed by the Bureau of Internal Revenue in such matters. The taxpayer in this case has seized upon the word "challenged" in the above quotation from the Supreme Court's decision in the *Virginian Hotel Corp.* case and first seeks (Br. 13, 36-40) to limit the decision in that case to cases where the excessive deduction for prior years "had never been challenged by the Commissioner or his agents" and that the decision in that case is inapplicable here "since the prior year depreciation involved in the instant case was challenged by the Commissioner and his agents". (Br. 36.)

We do not believe it necessary to enter into a discussion of whether or to what extent the decision in

the *Virginian Hotel Corp.* case could or should be limited because we see no merit to the taxpayer's argument here. The District Court found as a fact, on the evidence before it, that the Commissioner had "allowed" the deductions taken by the taxpayer in its returns for 1932 to 1935, inclusive, and that his allowance for the years here involved was fair and reasonable. (R. 127.) This finding is amply supported by the evidence.

The taxpayer's idea that its excessive depreciation deductions were "challenged" in this case seems to be based upon the fact that its returns for the prior years were examined by internal revenue agents; that the examining agents were aware of the excessive depreciation deductions; and that they conducted their examinations to the point where it was obvious that no tax liability would result from a disallowance of the excessive depreciation. But the Commissioner did not "challenge" the deductions. With this information he accepted the returns for 1932 to 1935, inclusive, as made and sent them to the closed files. There was no obligation on his part, legally or morally, to do otherwise. Accordingly the deductions claimed on the returns for those years were "allowed".

The taxpayer's argument (Br. 58-72) that under the circumstances the excessive depreciation deductions were not allowed and could not have been allowed is without merit. This argument is largely an unwarranted indictment of the Commissioner for condoning the dereliction of the taypayer in the prepara-

tion of its income tax returns for the earlier years and for not taking the initiative in correcting returns which the taxpayer itself knew to be erroneous. It is an attempt to justify or excuse its long dereliction by shifting the blame for its present predicament to the Commissioner. The duty was upon the taxpayer to file correct returns of its income. If it chose to file erroneous returns showing no tax due, and the Commissioner found upon a preliminary examination that there still would be no tax due if the errors were corrected, he was under no obligation to correct them. The taxpayer's argument (Br. 66-72) that upon the Commissioner's failure or refusal to correct its errors under such circumstances it should itself be allowed to correct its own errors has merit if the statute of limitations has not run. See I.T. 2944, XIV-2 Cum. Bull. 126 (1935). It says it should not be estopped to make such correction even if the statute has run if to do so does not result in a loss of revenue to the Government. (Br. 64-66.) But the Supreme Court held in the *Virginian Hotel Corp.* case that the statute here involved cannot be construed to permit such retroactive adjustment for the purpose of determining the basis for depreciation in a later year. The argument (Br. 40-50) that the legislative history of Section 113 (b)(1)(B) of the Internal Revenue Code requires that section to be interpreted so as to permit retroactive adjustment of prior year returns under the circumstances of this case was fully considered

and answered otherwise in the *Virginian Hotel Corp.* case.[5]

Whether, as taxpayer argues (Br. 30-72), the filing of amended returns is a recognized practice for correcting errors is true or not is not important here. The income tax laws have never provided for the filing of amended returns. The taxpayer's basis for depreciation for the years here involved is fixed by law and the filing of amended returns for earlier years long after the statute of limitations had run for those years can have no bearing upon whether the excessive depreciation deducted in the original returns was "allowed" within the meaning of Section 113 (b)(1)(B) of the Revenue Act of 1938 and the Internal Revenue Code.

This also answers the taxpayer's argument (Br. 73-75) that the District Court erred in denying its motion to vacate the order of submission and receive in evidence the letter it received from the Internal

[5]While they were not made a part of the record on review, the court below was furnished with copies of the briefs filed by the parties in the *Virginian Hotel Corp.* case, and also with a copy of the petition for rehearing which was denied by the Supreme Court. The petition dealt at length with Bureau procedure in handling income tax returns disclosing net losses and what counsel called the unfairness that would result from the Supreme Court's decision. Two specific examples of such alleged unfairness were set out in a footnote to the argument, one of them referring specifically to the Bank of America situation involved in this case, and a long letter from the tax counsel of the Bank of America to counsel for the Virginian Hotel Corporation commenting upon the Supreme Court's decision and its effect upon its own situation was attached to illustrate the point made about the unfairness of the decision. It must therefore be assumed that the Supreme Court had the present situation before it when it denied the petition for rehearing.

Revenue Agent in Charge. The contents of the report made to the Bureau of Internal Revenue in connection with the examination of the amended returns for 1932 and 1933 (R. 86-89) clearly show the letter in question was not material to the issue here involved.

Contrary to the taxpayer's argument (Br. 40-50), if the legislative history of Section 113 (b)(1)(B) of the Code is to be resorted to in interpreting the otherwise clear language of the statute, it clearly shows, as held by the Supreme Court, that Congress intended that depreciation bases should be adjusted by subtracting therefrom for depreciation in prior years the amounts "allowed" or "allowable" therefor in the prior years, whichever is the greater, as is provided in the applicable Treasury Regulations. See S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939-1 Cum. Bull. (Part 2) 496, 517).

Finally, the equities of the case stressed by the taxpayer (Br. 50-57) were also urged before the Supreme Court in the *Virginian Hotel Corp.* case but were disposed of by pointing out that Congress has elected to make the year the unit of taxation; that it has provided for annual deductions for depreciation; that under its interpretation of Section 113 (b)(1)(B) taxpayers may not thereby recover their investment tax-free but Congress has made no such guarantee; that Congress has indicated no intention to permit a second deduction where no tax benefit resulted from the first deduction; and that the policy

which does not permit a second deduction in the case of "allowable" depreciation is equally cogent in the case of "allowed" depletion.

CONCLUSION.

The decision of the District Court is right. It is supported by the facts and the law and should be affirmed.

Dated, April 20, 1948.

Respectfully submitted,

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(Appendix Follows.)

Appendix.

Internal Revenue Code[6]:

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

*   *   *   *   *   *   *

(l) *Depreciation.* A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

*   *   *   *   *   *   *

(n) *Basis for Depreciation and Depletion.* The basis upon which depletion, exhaustion, wear and tear, and obsolescense are to be allowed in respect of any property shall be as provided in section 114.

*   *   *   *   *   *   *

(26 U.S.C. 1940 ed., Sec. 23.)

Sec. 113. Adjusted Basis For Determining Gain Or Loss.

(a) *Basis (Unadjusted) of Property.* The basis of property shall be the cost of such property; except that—

*   *   *   *   *   *   *

(b) *Adjusted Basis.* The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the

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6The provisions of Sections 23 (l), (n), 113 (a), (b)(1)(B), and 114 of the Revenue Act of 1938, c. 289, 52 Stat. 447, are all the same as the corresponding provisions of the Internal Revenue Code.

basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.* Proper adjustment in respect of the property shall in all cases be made—

* * * * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws.

* * * * * * *

(26 U.S.C. 1940 ed., Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.* The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * * * *

(26 U.S.C. 1940 ed., Sec. 114.)

Treasury Regulations 103, promulgated under the Internal Revenue Code[7]:

Sec. 19.23(1)-4. *Capital sum recoverable through depreciation allowances.* The capital sum to be re-

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[7]The provisions of Articles 23(1)-4, 23(1)-5, 23(1)-9, 113(b)-1 and 114-1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, are substantially the same as the corresponding provisions of Regulations 103.

placed by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. * * *

Sec. 19.23(1)-5. *Method of computing depreciation allowance.* The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. * * *

A taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. * * *

Sec. 19.23(1)-9. *Records of depreciable property.* In order that the verification of depreciation allowances claimed by the taxpayer may be facilitated, depreciation shall be recorded on the taxpayer's books, the amount measuring a reasonable allowance for depreciation either being deducted directly from the book value of the assets or preferably being credited to a depreciation reserve account, which should be reflected in the annual balance sheet. * * * Also, the taxpayer's books shall show the basis of the depreciable property and any adjustments thereto * * *. If a taxpayer does not desire to have his regular books of account show all of the factors entering into the computation of depreciation allowances, such factors shall be recorded in permanent auxiliary records which shall be kept with and reconciled with the regular books of account.

Sec. 19.113(b)(1)-1. *Adjusted basis: General rule.*

The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost of such property * * * adjusted to the extent provided in section 113(b).

* * * * * * *

The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect to any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under chapter 1 or prior income tax laws. The adjustment required for any tax-

able year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted.

*   *   *   *   *   *   *

Sec. 19.114-1. *Basis for allowance of depreciation and depletion.* The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, except as provided in section 19.23(m)-3, relating to depletion based on discovery value, in section 19.23(m)-4, relating to percentage depletion in the case of oil and gas wells, and in section 19.23(m)-5, relating to percentage depletion in the case of coal mines, metal mines, and sulphur mines or deposits.